Valuation Methodology: Market Approach

Valuation within the sphere of financial services is often over-simplified for most business owners. For many, it's a paragraph or two within their Buy-Sell Agreement or a general multiple of revenue ascertained through the industry grapevine. Most owners of larger financial services businesses understand that the concept of valuation is important, but when dealing with the nuances of value, having only a basic understanding can negatively impact their business if misapplied.

Opinions from industry pundits tend to vary on the appropriate valuation methodology that should be applied to a financial services business. Ironically, they are all correct and simultaneously all wrong. This article serves as a cursory overview of generally accepted valuation methodologies within the financial services industry and the appraisal community at large, including the considerations of the commonly utilized methods and considerations for the application of each method. The goal here is that all stakeholders in a sale appreciate how value can fluctuate, that it may not be a single, easily determined number, and that there is give and take in understanding the overall process.

PURPOSE & STANDARD OF VALUE

Before considering what method is most appropriate for a singular valuation, an analyst or consultant must first consider the purpose at hand of the valuation to be performed. Just as a building rests on its foundation, the framework of valuation is grounded on its purpose. Situations vary, but by and large the purposes for a valuation are generally categorized as either tax or non-tax reasons. Both are applicable for the investment advisory industry. For instance, a business owner may need to value the entirety of his or her business for an external sale in the marketplace (a non-tax application) or may need to value a fractional interest in his or her business in conjunction with a tax filing resulting from the gifting of shares to an employee or family member (a tax application).

After purpose has been established, a standard of value must then be selected. "Standard of Value" deals with the perspective of value. In other words, the selection of a standard of value answers the question of "value to whom?" In an article published in the Journal of Financial Planning, Ryan T. Grau, CVA, CBA, outlines how the standard of value affects the valuation of a financial services business and points out that the two most common valuation standards in the financial services industry are Fair Market Value (FMV) and Most Probable Selling Price (MPSP).[1] FMV represents value on a cash or cash equivalent basis to a hypothetical buyer where neither the seller nor the buyer are under any compulsion to buy or sell. MPSP, however, can consider compulsion on the part of both the buyer and seller and can represent a value that includes

[1] Grau, R. (2017, November 01). What Is My Practice Worth? What You Need to Know About Value and Valuation. Retrieved from https://www.onefpa.org/journal/Pages/NOV17-What-Is-My-Practice-Worth-What-You-Need-to-Know-About-Value-and-Valuation.aspx

additional service contracts commonly included in the sale of a business, such as a post-closing consulting agreement.

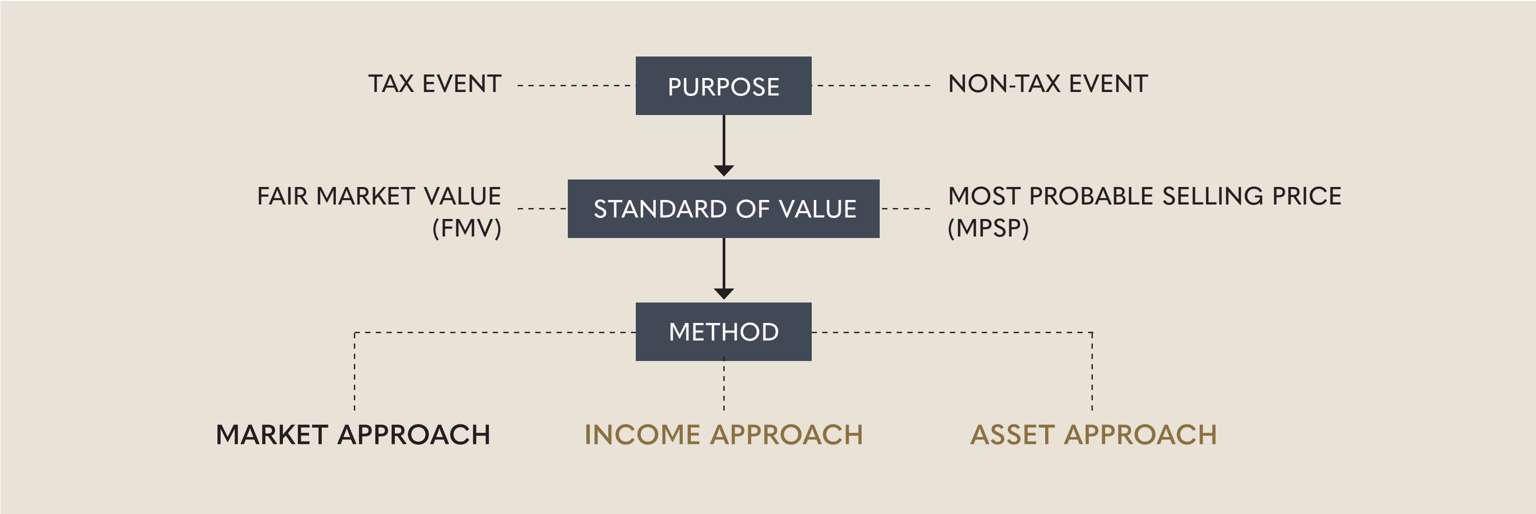
With the purpose and standard of value defined, the valuator can select and apply the appropriate valuation approach. Any valuation conclusion that does not first take into account the purpose and standard of value should be questioned.

There are three generally accepted approaches to valuation: the Market Approach, the Income Approach, and the Asset Approach. Under each approach, there are multiple methods for measuring and calculating value. The Asset Approach, however, is not commonly used to value financial services businesses as the ability to produce revenue is not dependent upon costly equipment and other tangible assets. Rather, the largest asset in a financial services business is an intangible asset; it is the goodwill established between the advisor and his or her clients. To determine the value of the intangible assets, an appraiser must first rely on the Income Approach and/or the Market Approach. What this means is that the majority, if not all, of the value calculated under the Asset Approach is reliant on the calculations of value using some other method. As such, this report will not be going into detail about the Asset Approach, but it will discuss the Market and Income Approaches and the various methods categorized under each approach.

VALUATION METHOD: MARKET APPROACH

The general theory behind the Market Approach is that in a group of transactions involving similarly structured businesses, the central tendency of the value ratios represents the value as determined by a free and open market. This method is dependent on the statistical relevance or variability within the transactions data to the value relationships being estimated. As represented by the Direct Market Data Method (DMDM), value is based on the sale of ownership interests in companies that are in the same or similar lines of business. The sale of ownership interests within this industry are typically characterized by the

Figure 3.1 Valuation Methodology Flow



sale of a 100% interest in the assets of a business. Once comparable transactions are found, the data is analyzed and evaluated for its dependability and then applied to the appropriate benefit stream of the subject business.

Database sources for comparable transactions, such as Institute of Business Appraisers, Bizcomps, and Pratt's Stats, are available on a subscription basis, but often lack sufficient detail about the operating characteristics of businesses within the financial services industry. The lack of detail is significant enough to erode the credibility of the valuation results and an appraiser's ability to apply the Market Approach. For example, these databases do not provide information about the revenue composition of the comparable transactions, e.g. what portion of the business's revenue comes from advisory fees versus annuity sales. Additionally, gross revenue is commonly referred to as "net sales" and is not distinguished as being either revenue paid to the broker-dealer—known as gross dealer concession—or gross revenue paid to the advisor after the broker-dealer charges its fees. In contrast, the FP Transitions databases include detailed information on operational characteristics, revenue compensation, and gross revenue productions to the advisor collected from over 1,500 transactions and over 11,000 business valuations in the last 20 years.

In the context of the financial services industry, our transaction data indicates that the most common type of sale of a financial services business is the sale of a 100% interest in the business's operating assets to a third party, or external buyer, on the open market in an arm's length transaction. These transactions are highly synergistic in nature; the average buyer is typically twice the average seller's size, is usually engaged in a similar line of business within the financial service industry, and already has components of the seller's infrastructure in place. These synergies give buyers the ability to eliminate redundancies in overhead expenses between the two businesses, thereby reducing the total cost to maintain the combined client base post-closing while still maintaining the capacity to service the breadth of the combined client base and leverage their existing business model to grow the combined revenue stream. This is the essential reason why an appraiser using the Market Approach will select gross revenue as the appropriate benefit stream as opposed to any other measure of earnings or cash flow. Using gross revenue removes the subjective process of estimating and forecasting earnings when the buyer is unknown to the seller, which is typically the case when a seller takes his or her business to market or when a business owner is establishing his or her value relative to the market as a benchmarking exercise. Our transactions data also indicates that historically there is a very high statistical correlation between the gross revenue of a business and the final sales price at which the business is transacted.

MARKET APPROACH: MARKET MULTIPLES

While gross revenue multiples are a widely used metric of marketplace value throughout the industry, there are other market multiples that come into play depending on the circumstances of a sale. The general assumption when determining a gross revenue multiple in the context of the financial services industry is that the buyer will acquire 100% ownership of the assets from the seller. Beyond a 12–18 month consulting period, there is generally no additional consideration within this multiple for the seller's continued involvement in the business. A gross revenue multiple also assumes that the buyer has existing operational infrastructure under which the clients will be serviced.

Applying a multiple against different types of earnings produces a market valuation that carries with it a much more varied set of assumptions. For example, a price/Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) multiple assumes that the business is sold with all of its operational infrastructure intact, including the reasonable salary attributable to an owner. EBITDA multiples are useful when a buyer is acquiring the business as a passive owner, in that the buyer will either retain the seller or replace the seller with a servicing advisor and has included in the sales price the consideration of compensation for the individual who will actively run the business. For this reason, EBITDA multiples are commonly used by both regional and national "roll-up" firms and private equity groups who are looking for acquisition opportunities to add to their portfolios.

Below is a brief chart summarizing different market multiples used in the financial services industry and the built-in assumptions inherent in their use. It is imperative when using market multiples that the selected multiple is only used in tandem with the benefit stream from which it was derived.

MARKET APPROACH CONSIDERATIONS: STRUCTURE AND PROFITABILITY

When discussing approaches to valuation within the financial services industry, it is important to keep in mind the general structure of the businesses that are being transacted in the market place. David Grau Sr., JD, goes into detail about these different business structures (classified as book, practice, or enterprise) in his article "The Impact of Consolidation," on page 7 of this report.

The various structures within the financial services industry dictate how each of these businesses will be sold and how they are subsequently valued. Typically, the only exit

Table 3.2 Application of Market Multiples

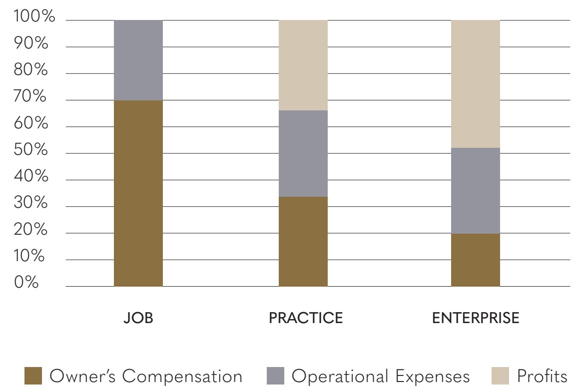
MULTIPLE	BENEFIT STREAM	ASSUMPTIONS
Price/Gross Revenue	Gross Revenue/GDC	Buyer has operational infrastructure in place and requires 100% of seller's assets.
Price/EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortization	Buyer is acquiring assets and maintaining seller's operational infrastructure. Seller or servicing advisors will remain to service practice.
Price/EBOC (SDE)	Earnings Before Owner's Compensation (Seller's Discretionary Earnings)	Buyer is acquiring assets and maintaining seller's operational infrastructure. Buyer will be the primary service advisor.
Price/Assets	Total Assets (AUM)	Buyer has operational infrastructure in place and acquires 100% of seller's assets.

strategy, other than attrition, for book owners or practice owners is an external sale on the open market.

Our data shows that sales of these businesses are almost exclusively transacted as asset sales to a third party where the owner remains with the business for approximately 12–18 months post-closing to assist in the transition of client relationships. From a pricing standpoint, the Direct Market Data Method under the Market Approach is an appropriate method of valuation, as it caters to the common exit strategy of an advisor who owns a book or practice. The gross revenue multiple is also a common tool used under this Market Approach methodology, as the majority of books are purchased by practices that have existing infrastructure, and the majority of practices are purchased by other practices or enterprises that are, generally speaking, about twice the size of the acquired practice by gross production. Because they need to acquire little to no operational infrastructure, external buyers are primarily concerned with the gross revenue they can add to their top line, which caters to the use of a gross revenue multiple.

The story is not the same with the sale of enterprises. The organizational and compensation structures of an enterprise—as opposed to that of a book or a practice—gives owners additional options for their exit strategy. If enterprises are sold externally, they are rarely acquired by a smaller enterprise, let alone a practice or a book. In many cases, enterprises tend to view an external sale as a last resort, instead pursuing internal succession as a preferred and more beneficial exit strategy. In this instance, the Market Approach isn't necessarily the best indication of value and the use of a gross revenue multiple becomes less relevant. Whereas the buyer of a practice may have top-line production in the form of gross revenue as its target, an investor in an enterprise is looking for a "bottom-line" revenue stream—the enterprise's profits—as a return on his or her investment.

Figure 3.3 Benefit Streams by Business Structure



While the Market Approach is very useful to determine the value of books and practices, the value of enterprises that are generating profits at levels illustrated in Figure 3.3 is less in the revenue-generating capacity of the enterprise (although still important) and lies more in the company's ability to generate profits. The Market Approach can still provide a good proxy for the value of an enterprise in an external transaction. However, enterprises are built to transition ownership internally and more often leverage this option rather than selling externally. Therefore, most valuations of businesses at this level more appropriately use the Income Method discussed further on page 48.

As a financial business grows its market footprint and evolves its organizational structure, its value will change in accordance with its size and sophistication.

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